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Surge in Chinese Government Debt and 'Stimulus' Loans Threatens Sustainable Recovery

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A recent article appearing in *Risk Review Magazine* entitled, “Reassessing China’s Sovereign Risk” (see link below), reveals that the economic story coming out of China may be too good to be true.

China's state banks approved a combined 4.58 trillion yuan in new loans during the first quarter of 2009, a remarkable cash surge equal to the total amount of bank lending for all 2008. Chinese state-owned banks Industrial & Commercial Bank of China Ltd., China Construction Bank Corp. and Bank of China Ltd. tripled first-quarter lending to $670 billion as part of a government stimulus package.

ICBC advanced 636.4 billion yuan ($93.3 billion) of new loans in the first quarter, almost quadruple the amount extended in the same period a year ago and more than the bank’s total lending last year. China Construction offered 521 billion yuan of new credit in the first three months, compared with 161 billion yuan a year earlier. Bank of China made 511 billion yuan of new loans, more than twice the amount a year earlier. All three banks are state-owned and based in Beijing.

“We suspect some of the banks may have compromised their risk-management and risk-aversion attitude to meet targets and government expectations,” said Wen Chunling, a Beijing-based analyst at Fitch Ratings. “That will lead to a rebound in non-performing loans in the next few years.” (*Bloomberg*, April 30). Some of the loan recipients in turn lend proceeds to firms that don’t qualify for financing from banks, increasing the risk of defaults spreading through the economy. In other cases, corporate loans are being used to cover operating expenses rather than investments.

Shanghai-based China Eastern Airlines Corp., the nation’s third-largest carrier, has received 87 billion yuan of credit lines from China Construction, Bank of China, China Development Bank Corp., Bank of Communications Co. and Shanghai Pudong Development Bank Co. since December. The company, whose liabilities exceed assets by $1.8 billion, posted a record $2.2 billion loss in 2008 and has received $1 billion of government bailout money.

“Could the economic situation become so bad in China that it threatens the regime itself?” Albert Edwards, a London-based global strategist for Societe Generale SA asked earlier thus year.. “Of course it could, and clients should consider the implications of such an event.” And Mr. Edwards is not alone; Arthur Kroeber, editor of *China*

Economic Quarterly, says that hidden debt in China's corporate sector is higher than revealed by official bank-loan data, since 44 per cent of corporate capital expenditure in 2008 was financed by money whose source is literally unknowable.

Stimulus Package

China's 4 trillion yuan stimulus package requires less than 1 trillion yuan of annual lending, according to Deutsche Bank. Banks lent 1.89 trillion yuan, almost twice that amount, during March. "We don't know the whereabouts of the rest of the lending," said Ma Jun, chief China economist at Deutsche Bank AG in Hong Kong. "This is where the default risk comes from. A lot of signs have shown that most of the loans offered in the first quarter didn't go to the infrastructure sector. There are a lot of companies that borrowed not for the need of business expansion, but rather were talked into borrowing by banks," he said. Even lending to local governments may be risky, Deutsche Bank's Ma said. Such loans, typically maturing in more than five years, may not be repaid in full, according to the economist.

There has been a surge in bankruptcies among small and mid-size companies in coastal areas, said Peng Xingyun, director of the monetary policy division at the Chinese Academy of Social Science in Beijing. At least 7.5 percent of the country's 42 million small and medium-size enterprises had closed or suspended operations by the end of last year and about 30 million migrant workers have lost their jobs, according to official statistics. "There will be a one-year lag before bad loans start to emerge," Peng said.

"If the stimulus package fails to revive the economy, a lot of loans will turn sour, that's for sure," said Lan Wang Simond, who helps manage $5 billion at Geneva-based Pictet & Cie Banquiers.

Risk Control

But the government's policy may be putting economic growth ahead of structural adjustment and risk management.

In an article entitled, "China's Loan Binge: Stimulus or Insanity?" (Caijing, May 6, 2009), Bankers, local officials and financial regulators are reportedly trying to explain, and justify, the stunning surge in new loans, which showed no sign of letup in the second quarter. Even after China Banking Regulatory Commission [CBRC] Chairman Liu Mingkang called for "moderating" the loan pace in April, the loan writing has continued, raising key questions for China's economy. Has this trend -- fanatical to some, sensible to others -- helped ease deflation and actually bolstered the economy? Or has it raised inflation risks and damaged financing mechanisms?

The article states that, "ICBC, Bank of Agriculture and Bank of China actually accelerated the pace of new loans as the quarter drew to a close. A risk management executive at another commercial bank reportedly said that none of the banks can afford to sit on the sidelines in the current race for loan customers. More than business is at stake. Top executives at the Big Four banks are also government officials with vice minister-level positions. So in addition to caring for their banks, they are responsible for supporting the central government's economic stimulus policy. But pressure from the central government in Beijing may be even greater. According to a local branch executive at a state-owned bank, local branches have been asked by central authorities to increase lending several times since the beginning of the year.

The conflicting signals can be even more bewildering considering that the State Council, China's cabinet, as well as government monetary authorities appear completely at-ease over the soaring credit levels." According to the article, the deputy governor of the People's Bank of China stated that the central bank would not restrict the scale of lending, and would "continue following a relatively loose credit policy."

The article reports that such an unprecedented increase in credit lending also poses remarkable challenges for bank risk management. A corporate loan executive at a state-owned bank is quoted as stating, "For the time being, project lending and liquidity lending control have been loosened to an extreme. Although it is challenging for banks to assess the true fiscal condition of local governments, excessive liabilities only steal from the future".

Caijing further reports that “Beijing regulators have signaled that the capital bases for some projects are seriously inadequate. This came when regulators gave a green light to bridge loans for financing projects approved by the National Development and Reform Committee, which plans to lower capital base requirements for certain projects. At the same time, regulatory authorities are concerned about loan misappropriation at the local level. Several bankers told Caijing that many local banks have been under pressure to issue loans for local projects in response to the central government's economic stimulus plan.

Now, some fear that cash may have been misappropriated. Such abuse could be tied to bank loans issued to meet local liquidity needs, to back letters of credit, and for buying securities. Moreover, a corporate banking executive said some big enterprises have been known to concentrate capital by pooling their loans and recycling the cash. When that happens, banks lose control over the direction of their loans. And when big companies are unwilling to increase capital investments, citing concerns about the economic cycle, borrowed money is likely to flow into the stock market and real estate for speculation. But as the international investment bank executive explained, ‘For a long time into the future, it is very likely to have economic recession together with big, crazy bubbles in the stock and real estate markets. This will be a new, messy and distorted situation.”

Risk of Resurgent Inflation

As a result of the economic slowdown, U.S. consumers are buying a whole lot fewer things that say 'Made in China.' "That means a lot less business for China's manufacturing sector, which translates into less tax revenue for the Chinese government and the need to print more money, leading to the very real risk of hyperinflation. Respected economist Michael Pettis observes: "A decline in U.S. consumption equal to 5 per cent of U.S. GDP, for example (which is a low estimate), would require an increase in Chinese (domestic) consumption equal to 17 per cent of Chinese GDP - or a nearly 40 per cent growth in consumption." Given that the average annual income per person in China is $2,000, Andrew Milligan, the head of global strategy at Standard Life Investments, which oversees $181 billion, states “I can’t see any way that China is the locomotive that pulls the world out of recession. It’s difficult for people to buy the China story.”

“The apparently willful ignorance of the risks posed by investments in long-term Chinese government and corporate bonds causes me to wonder why so many economists, who also missed the boat on predicting the depth of the global credit crisis, seem to be drinking Kool-Aid when it comes to China” wrote Sovereign Advisers risk analyst Kevin O’Brien in a recent research note.

Defaulted Debt May Restrict China’s Access to Foreign Borrowing

As if the escalating risks posed by massive credit creation, which appears to be continuing unabated, were not enough the central government’s defaulted full faith and credit sovereign debt represents a disclosure obligation which may act to impair or restrict its ability to engage in future external bond issues. Defaulted creditors have threatened litigation in an attempt to intercept payments to other equally-ranked creditors of the Chinese government. The United States Congress has even introduced concurrent resolutions (Sen.Con.Res. 78 and H.Con.Res. 1179) labeling China’s “investment-grade” sovereign credit rating as artificial.

The article is accessible at:

http://www.garpdigitallibrary.org/download/GRR/2089.pdf

The United States Senate and House Concurrent Resolutions are accessible at:

http://globalsecuritieswatch.org/S.Con.Res.78.pdf

http://globalsecuritieswatch.org/House_Con_Res_1179.pdf